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Extra-territorial Operations of Indian Income-tax Act, 1961, and Treaty Override

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Extra-territoriality

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The rationale

- A person can be taxed either on the basis of:
  - **Residence**: Country gets taxing right by virtue of residency of individuals.
  - **Source:** Country gets taxing rights by virtue of the individual earning income in that country
- The sovereign right of state **to manage internal affairs** within its territory is corollary to its duty to **not to intervene in the internal affairs of other states**
- Jurisdiction to tax is a **manifestation of sovereignty**
- **Nexus Theory**: The question of extra-territoriality arises when a jurisdiction imposes a tax on certain income with has a connection outside its jurisdiction.

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Article 245: Extent of laws made by Parliament and by the Legislatures of States

Subject to the provisions of this Constitution, Parliament may make laws **for** the whole or any part of the territory of India, and the Legislature of a State may make laws for the whole or any part of the State.

No law made by Parliament shall be deemed to be invalid on the ground that it would have extra-territorial operation.

Whether the extra-territorial operation of law is permitted in India?

Governor-General In Council v. Raleigh Investment Co. Ltd

[1944] 12 ITR 265 (FDC)

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FACTS

- Plaintiff was a company incorporated in England and had no business premise in India but held the bulk of shares in eleven companies which carry on the business of manufacturing and selling tobacco and cigarettes in India. Two of the eleven were Indian companies, the rest were incorporated in England. All of them were controlled from London, the share registers are situated there, and their dividends are declared there.
- The eleven companies were assessed, and income tax was levied on all of them, including the nine companies incorporated outside India.

Section 4(1)(c) of the Income-Tax Act, 1922: the total assessable income of a non-resident shall include income which accrues or arises or is *deemed to accrue or arise* to him in British India.

- *Explanation 3* to sub-section (1) enacts "that a dividend paid without British India shall be deemed to be income accruing and arising in British India to the extent to which it has been paid out of profits subjected to income-tax in British India

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- In any event, so much of the provisions as may seem to operate extra-territorially must be held to be valid on the ground that they were ancillary or incidental to the authorized portion of the legislation and were required to make its exercise effective.
- The purpose of the impugned provisions is obviously to *increase* the extent of the income which is to be taxed for the benefit of the Indian Exchequer.
- The earlier provision (which reproduced the language of still earlier statutes) conferred on the Indian Legislature "power to make laws (*a*) for all persons, for all Courts and for all places and things within British India, (*b*) for all subjects of His Majesty and servants of the Crown within other parts of India, and (*c*) for all native Indian subjects of His Majesty without and beyond as well as within British India, etc. etc
- It was held that, if there is any extra-territorial operation with the impugned provision, it is within the legislative powers given to the Indian Legislature by the Constitution Act of 1935.

Electronics Corporation of India Ltd v. CIT

[1990] 183 ITR 43 (SC)

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FACTS

- The Assessee received technical services from a Norwegian Company, including facilities for the training of personnel abroad.
- The Appellant approached ITO to grant NOC for remitting the payment without the obligation to deduct any income-tax at source.
- The request was rejected by the ITO, stating that the payment constituted income under Section 9 read with Section 195 of the IT Act and was liable to deduction of tax at source.
- The Petitioner approach the High Court challenging the constitutional validity of Section 9(1)(vii) on the ground of its extra-territorial operation without any nexus between the person sought to be taxed and the country seeking to tax.
- The High Court dismissed the appeal. Aggrieved, the assessee approached the Supreme Court with the same grounds for challenge.

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- Article 245(2) declares that no law made by the Parliament shall be deemed to be invalid on the ground that it would have extra-territorial operation. Therefore, a parliamentary statute having an extra-territorial operation cannot be ruled out from contemplation.
- The general principle, flowing from the sovereignty of States, is that laws made by one State can have no operation in another State
- While the enforcement of the law cannot be contemplated in a foreign State, it can, nonetheless, be enforced by the Courts of the enacting State to the degree that is permissible with the machinery available to them. They will not be regarded by such Courts as invalid on the ground of such extra-territoriality.

Whether a nexus with something in India is necessary?

- It is inconceivable that a law should be made by the Parliament in India, which has no relationship with anything in India. The only question is then whether the ingredients in terms of the impugned provision indicate a nexus.

GVK Industries Ltd v. ITO

[2011] 332 ITR 130

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FACTS

- Assessee company was incorporated with the purpose of setting up a gas-based power project in Andhra Pradesh. ABB (Swiss Company) rendered professional services from Zurich by correspondence as to how to execute the documents for sanction of loan by the financial institutions within and outside the country. Pursuant to the services provided, assessee made certain payments to a foreign company. The Department was of the view that the assessee was liable to withhold tax on those payments as they were within the ambit of "sum chargeable to tax" under Section 195 of the IT Act.
- The department held that the sum was income deemed to accrue or arise in India under Section 9 of the IT Act.

(1) Is the Parliament constitutionally restricted from enacting legislation that has extra-territorial operation

(2) Does the Parliament have the powers to legislate "for" any territory, other than the territory of India or any part of it?

INTERPRETATION ASPECTS

What is "Extra-territorial aspects or causes that have nexus with India"?

Aspects or causes that occur, arise, or exist outside the territory of India but may have consequences for:

(a) The territory of India, or any part of India; or

(b) The interests of, welfare of, well-being of or security of inhabitants of India, and Indians in general, that arise on account of aspects or causes

Narrow Interpretation	Broad Interpretation
• The Parliament has the power to make laws is related to India-specific subject i.e., the law must arise solely "in" or "within" the territory of India	• the Parliament is empowered to enact laws that are in the interest of, to the benefit of, in defence of, in support or favour of, in respect of or with reference to "the whole or any part of the territory of India".

Propositions for Parliament's power From Restricted to Liberal

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Parliament's powers to legislate incorporate only competence to enact laws with respect to aspects or causes that occur, arise or exist, or may be expected to do so solely within India.

Parliament's competence to legislate with respect to extra-territorial aspects or causes would be constitutionally permissible if and only if they have or are expected to have a significant or sufficient impact on or effect in or consequence for India

as long as some impact or nexus with India is established or expected, then the Parliament would be empowered to enact legislation with respect to such extra-territorial aspects or causes

Parliament has inherent powers to legislate "for" any territory, including territories beyond India, and that no court in India may question or invalidate such laws on the ground that they are extra-territorial laws

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- **The Parliament may exercise its legislative powers with respect to extra-territorial aspects** that occur, arise or exist or may be expected to do so, naturally or on account of some human agency, in the social, political, economic, cultural, biological, environmental or physical spheres outside the territory of India, and seek to control the effects of such extra-territorial aspects or causes **only when such extra-territorial aspects** or causes have, or are expected to **have, some impact on**, or effect in, or consequences for:

  (*a*) the territory of India, or any part of India; or

  (*b*) the interests of, welfare of, the well-being of, or security of inhabitants of India, and Indians

- **The Parliament does not have the powers to legislate "for" any territory, other than the territory of India**. Any laws enacted by Parliament with respect to extra-territorial aspects or **causes that have no impact on or nexus with India** would be ***ultra vires***,

Treaty Override

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OECD's Perspective on Treaty Override

- If a country amends its domestic provisions in violation of Treaty provisions, it is considered as a violation of international law.
- However, if the contracting states enforce amendments which substantially erode another country's tax base, the latter is permitted to enact amendments to nullify the effect.
- The violation is considered as a violation of both domestic and international obligations
- Eg: Thin Capitalization Rules and GAAR provisions.

Treaty Override

- The provisions of Tax Treaties will prevail even if there are special provisions in the Act. For e.g. FIIs
- Non-Discrimination provisions of Tax Treaty override the domestic Provisions
- Where Treaty is silent, Income-Tax provisions will apply.
- Tax Treaties cannot create more onerous obligations or liabilities than Income-Tax provisions
- It’s states’ responsibility to bring harmony between international law and municipal law. However, in case of conflict, the power of Parliament cannot be subjected to external rules [***Gramophone Company of India Ltd v Birendra Bahadur Pandey AIR 1984 SC 667***]
- Overriding effect of Domestic provisions over Treaty: GAAR and Equalisation Levy

Union of India v. Azadi Bachao Andolan and Ors

[2003] 263 ITR 706 (SC)

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FACTS

- Under India-Mauritius DTAA, capital gains are not taxed in the source state – Mauritius domestic tax law does not tax capital gains and this leads to double non-taxation
- In early 2000, some Indian tax officials rejected Mauritius tax residency certificate of certain financial institutional investors and sent notice of demands on them to deny capital gains exemption under the treaty
- CBDT issued Circular 789 to its officials to honour the certificate and grant dividends and capital gains relief under the India-Mauritius treaty on Indian Government advice.
- A writ petition was filed in Delhi HC as a public interest litigation that the CBDT circular was illegal and the HC ruled against the CBDT
- Subsequently Indian government and a Mauritius NGO filed an appeal in the SC that overruled the HC decision in 2003

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- Tax treaties cannot create more onerous obligation than that provided under the act or fasten a tax liability where the liability is not imposed by the domestic law
- Liability to tax is a legal situation while payment is a Fiscal Act. For applying the treaty it is not necessary for actual tax to be paid.
- **Section 90 enables Central Government for implementation of DTAA and hence, provisions of DTAA will override that of the Income-tax Act 1961, wherever inconsistencies arise.**
- When that happens, the provisions of such an agreement, with respect to cases to which they apply, would operate even if inconsistent with the provisions of the Income-tax Act.
- Treaty residence is based solely on the domestic law of the contracting state and motives for incorporation by a resident are wholly irrelevant and cannot affect the legality of the transaction

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Engineering Analysis Centre of Excellence (P.) Ltd v. CIT

[2021] 432 ITR 471(SC)

FACTS

- The assessee-company (EAC) was a resident Indian end-user of shrink-wrapper computer software, directly imported from the United State of America (USA).
- The AO held that what was in fact transferred in the transaction between the parties was copyright which attracted the payment of royalty and thus, it was required that tax be deducted at source by EAC.
- The Karnataka HC held the payments constituted “royalty” under Section 9(1)(vi) of the Act
- The definition of royalty under ITA is broader than that provided in the DTAA.

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Whether Treaty Provisions override Income-Tax Act Provisions?

- Once it is held that payment made by the respondents to the non-resident companies would amount to "royalty" within the meaning of article 12 of the DTAA with the respective country, it is clear that the payment made by the respondents to the non-resident supplier would amount to royalty.
- Article 12 of the aforesaid treaty defining "royalties" would alone be relevant to determine taxability under the DTAA, as it is more beneficial to the assessee as compared to section 9(1)(*vi*) of the Income-tax Act.

Thank you!